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ABSTRACT

Four aspects of the Guaranteed Student Loan (GSL) Program are compared with credit policies on other loans made by consumer installment lenders. The four aspects are: (1) the planning, screening, monitoring, collecting, and write-off policies on GSLs versus uninsured loans; (2) the importance of the Student Loan Marketing Association in providing a secondary market for student loans and servicing other needs of consumer lending institutions; (3) consideration of the effects of past growth in the GSL program in shaping its expected future role; and (4) recommendation of alternative GSL policies to induce behavior by lenders, borrowers, and participating institutions that will ensure the continued viability of the GSL program during the next decade. Four areas of concern are as follows: the lack of screening of credit applicants for their prospective creditworthiness; criticism that students are not using GSL funds to finance their education; that Sallie Mae remains a viable intermediary in the GSL market; and that participating credit institutions will maintain their support of the GSL program. Six GSL credit policy recommendations are offered. (SW)

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Toward Improvement of Credit Policies on Guaranteed Student Loans

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I. Introduction

This paper compares four aspects of the Guaranteed Student Loan Program (GSL) with credit policies on other loans made by consumer instalment lenders. The four aspects are:

1. the planning, screening, monitoring, collecting and write off policies on GSL's versus uninsured loans,
2. the importance of the Student Loan Marketing Association (Sallie Mae) in providing a secondary market for student loans and servicing other needs of consumer lending institutions,
3. consideration of the effects of past growth in the GSL program in shaping its expected future role, and
4. recommendation of alternative GSL policies to induce behavior by lenders, borrowers and participating institutions that will ensure the continued viability of the GSL program during the next decade.

The bases for the recommendations made are almost entirely drawn from materials supplied by the staff of the National Commission on Student Financial Assistance. Major reliance has been placed on three sources: the National Commission's background paper on the GSL program,[1] and two large-scale surveys conducted in 1975 and 1981.[2] In addition, interviews were held with a small number of small, medium-sized and large GSL lenders to obtain personal insights into the attitudes and policies identified by the respondents to the surveys.

II. Comparison of GSL Credit Policies with those on Uninsured Loans

The GSL loan is a peculiar animal to bankers and others responsible for making them. As the 1982 Wharton report makes clear (Kendis, Sec. B.4),

bankers do not know exactly where to locate GSL's in their banks, how to fit them into their profit centers, or how to develop the data processing capabilities that will minimize the processing costs. The earlier 1973 report (Gordon, Office of Education) revealed that default experience was bad (17.9% of accepted applicants). Paperwork costs were high and the problems of finding defaulters to establish claims were responsible for what was perceived at that time to be lower profitability on GSL loans than on uninsured loans. But since that time the 1976 amendments sweetened the pot by tying the special allowance paid lenders to quarterly changes in the 91 day Treasury bill rate followed by the removal of any cap or limit on the special allowance. Also, Sallie Mae has provided a limited secondary market for student loans, but the loan must be sold before the student leaves the educational institution, leaving the bank with the loan for the remainder of its life after the repayment period has been set up. But Sallie Mae also offers a warehousing loan service where loans to the lending institution are backed by GSL's to provide liquidity when needed. However, in the 1982 report, almost two-thirds of the lender respondents regarded the GSL's administrative burdens as having increased since 1975 and are greater than those incurred on other consumer instalment loans.

It is likely that lending institutions incur some lower costs on GSL's than on uninsured loans because they need not take the same care (or spend as much) in screening credit applications or collecting loans when delinquency has progressed beyond a certain point because default losses are insured. To be sure, they want to hold down delinquency, but there are special problems in doing so in the way that they do when they make uninsured instalment loans.

Lenders commonly classify their activities in making consumer instalment loans into the following categories:

A. Planning the service to be offered

B. Screening and accepting credit applications

C. Monitoring and servicing loans

D. Collecting delinquent accounts

E. Writing off uncollectible accounts

To identify differences between the treatment of GSL's and other (uninsured) consumer instalment loans, these categories will be treated serially.

A. Planning the service

The Wharton report of interviews with lenders revealed that decisions to make GSL's often were not made in the same way or with the same information that leads to the decision to offer other types of consumer instalment loans. Generally, the planning unit of the bank and/or the department responsible for consumer instalment loans selects the portion of the market that can be served profitably, develops a marketing plan, engages in preliminary studies leading to the adoption of criteria for accepting or rejecting applicants, and tests the service in selected market areas before offering the service in all branches of the organization. Contrast this procedure with the Wharton interviewers' observation on the responses to their inquiries:

> Too often the initial motivation for the bank's desire to make guaranteed student loans came directly from an executive who did not have complete knowledge, yet was dealing in political issues for the bank. For example, pressure by a state guarantee agency on a chief executive officer could certainly initiate the creation of a guaranteed student loan operation in a bank, although no knowledge of actual operational requirements would have come into play. The peculiar nature of the Guaranteed Student Loan Program, where there is a considerable

> lead time before a lender has to service the loan, has structured decision making on the part of the banks into several portions. The decision to make the loan is often followed by (emphasis added) the decision to prepare to service the loan or develop the necessary computer support to service the loan. This structure of decision making, when compounded by the desire to use a secondary market, makes guaranteed student loans unique among instruments available to the bank and, therefore, often not understood by the banks themselves.[3]

It is likely that organizations, such as money center banks, analyze the participation in the GSL program quite carefully, since they have the resources and staff to provide the computer support necessary to serve a large volume of applications efficiently. But many other participants do not, including some interviewed by this author, and simply sell all student loans to Sallie Mae before the student leaves the educational institution. Many small banks appear happy to service the loans as long as the loans were made to students who came from their communities, relying on local knowledge to justify their participation. Clearly, the reports indicate that participation in the GSL program is widespread but relatively few banks aggressively promote student loans in most market areas. The point to be made here, however, is that planning for the offering of GSL's is not comparable to the planning for uninsured loans.

B. Screening and accepting credit applicants

Most consumer lending done in volume has to be highly automated, as the relatively small size of balances cannot support a large labor input to establish the creditworthiness of applicants. Most high volume lenders have engaged consultants to develop (or developed themselves) empirically-derived, statistically validated credit scoring systems which predict the probability that an applicant will default, assign a numerical score and

lower the cost and time spent judging credit applications. In addition, credit reports are available from private credit reporting agencies at reasonable but significant cost which inform lenders about the current standing of applicants with respect to their repayment habits. Lenders with statistically based credit scoring systems will either use credit reports as part of the information fed to their scoring systems or use them only on applicants which have marginal scores. The latter method avoids the expense of getting a credit report for every applicant. Scoring systems simply identify the relative probability of repayment for a sample of applicants, some of whom have performed satisfactorily (repaid regularly) versus those who performed unsatisfactorily (defined as problem delinquency or default). The scores are developed from the identification of borrower and contract characteristics associated with good or bad performance on a sample of loans that have been made by the lender in the past.

There is little evidence that much credit screening on GSL applications is done by the lending institution beyond that provided by the financial aid officer of the educational institution to certify the eligibility of the applicant for a GSL. The information forms filled out by students reviewed by the author contained only requests for student loan debts outstanding at the time of the application and a question involving whether there had been a previous default on these loans. If so, information about arrangements for repayment were required. No information was requested about other debts or repayment habits.

The Wharton survey revealed that a few qualifications are required for students to receive student loans, either by the state agency guaranteeing the loan or by the lender. The relevant proportions of lending

institutions answering affirmatively were:

Requirement	% of respondents
Resident of state or region	78
Customer of institution	64
Need	45
Type of school specified	28
Grade point average	17
Location of school in state or region	12
Minority group member	2
Employee relatives	4

The major criteria specified by a majority of respondents were residency in state or region and being a customer (having an account in) of the institution. A large minority of respondents required evidence of need, but this has now become a requirement of the current program. By and large, not many institutions adhere to criteria investigating creditworthiness which are typically associated with consumer instalment lending other than the first two criteria cited.

Thus the criteria for accepting applications for GSL's differ markedly from those used to accept other consumer instalment loans. Given this difference, it should come as no surprise that aggregate default rates on GSL's appears to be substantially higher than default rates on other consumer instalment loans. Yet lenders responding to the Wharton Survey questionnaire were divided as to whether the default rate was lower or higher on GSL's in their portfolios relative to other consumer instalment loans. Small banks reported lower defaultrates for GSL's, medium sized banks the same and large banks higher defaultrates for GSL's than on other consumer instalment loans. These responses must be interpreted carefully, since the relative importance of the different-sized banks in the GSL total picture could obscure the aggregate default rate.

C. Monitoring and servicing consumer instalment loans

Monitoring and servicing of GSL's requires some special considerations that differ from those on other consumer instalment loans. There are three distinct periods during the life of a GSL: the in-school period (or periods), the grace period, and the repayment period. In addition, the lender must be prepared for borrower requests to defer repayments if they continue their educational career, or for a variety of other permissible reasons specified by law. The possibility of deferment means that an intended repayment period of between five and ten years may be stretched out for a longer time legally without the consent of the lender.

During the in-school period, monitoring the progress of the student is largely the responsibility of the educational institution, and there is little loan servicing other than collecting interest and the special allowance since the student does not begin to repay the loan until the grace period has expired. During the in-school period, the lender must maintain records concerning the progress of the student and notification sent to the appropriate guaranteeing agencies. Any decision to sell the loan to Sallie Mae, as noted earlier, must be made during the in-school period but at least eleven months before the end of the grace period. On the other hand, if the GSL loan is made to a parent or to a financially independent undergraduate or graduate students who borrow under the PLUS or ALAS options, repayment of interest begins within 60 days after the loan is made, although principal repayment may be deferred until the student leaves school or falls below full-time status. In such instances, lenders have added monitoring and servicing expenses.

During the grace period, the lender must find the student and negotiate

the terms of repayment. Once terms are set, servicing procedures are comparable to those followed in consumer instalment loans, and monitoring procedures are similar as well. A major difference, already noted, is that when a borrower becomes delinquent on an uninsured loan, the lender has the option to accelerate repayment and place the loan in default. If a student borrower becomes unemployed (up to one year), or is disabled (up to three years) or enters into a variety of other authorized employment opportunities (Armed Forces, Public Health, Peace Corps, Action, volunteer for tax-exempt organization), the borrower may request deferment. The lender may file for default claims only under conditions specified by law but which do not vary materially from those customarily followed on uninsured loans. Thus, the main difference between maintaining and servicing GSL's and uninsured consumer instalment loans is that there may occur irregularities in the GSL repayment period over which the lender has little control.

D. Collecting delinquent accounts

The initial procedures for handling delinquent accounts for GSL's and uninsured consumer instalment loans are similar. Indeed, the GSL program requires that lending institutions adhere to "due diligence" in awarding, servicing and collecting loans. Due diligence is defined as adhering to the standards that financial institutions follow in administering all consumer loans.[4] In collections, this means taking "all steps necessary to collect payments from borrowers who may be difficult to locate, reluctant to pay, and/or legitimately encountering financial hardships."[5]

It is customary for lenders to send delinquent notices, and follow up the notices with telephone calls or telegrams to be able to assess the causes of delinquency and work out an arrangement to handle the customer's

short term or longer term financial problems. If the borrower is difficult to locate, his or her employer may be contacted. When reluctance to repay is the cause, the lender might turn the obligation over to a debt collection agency which would, in return for some percentage of the principal recovered, pursue the borrower more closely than the lender, under constraints placed on debt collectors by federal law. If uncollectible, the lender would turn to a lawyer, either in-house or outside counsel, to take the matter to court. It is unlikely that "due diligence," as applied in the GSL program, requires that the lender take all such steps. In the 1975 Office of Education survey, lenders reported that their attempts to contact GSL borrowers who were in default included letters and/or telegrams to borrowers (94% of respondents), letters or telegrams to schools (40%), telephone to borrower (75%), communication with borrower's family (66%), outside assistance from the federal government (59%), outside assistance from the state or private agency (24%), and other unspecified means (25%).[6] Seeking court action is not required to qualify for due diligence, since the service is costly and often requires more time than allowed. The federal government, however, assumes this obligation when the default is reimbursed. The omission of this step by the government could mean that recoveries of defaulted loans are fewer under GSL loans than on uninsured consumer instalment loans of similar sized unpaid balances. Further investigation of this aspect of collection policy is needed before a firm conclusion can be drawn.

E. Writing off uncollectible accounts and obtaining reimbursement

The procedure required of lenders to qualify for reimbursement includes a request to the guaranty agency for assistance 60 days after a loan payment

is overdue. After 90 days a registered letter must be sent to the borrower, explaining that the loan will be sent to the government for collection and the possibility of legal action. After 30 more days, the claim for recovery can be made, accompanied by evidence of the efforts made by the lender and the guaranty agency to collect the loan. The federal government then remits to the guaranty agency, if any, or directly to the lender.

According to this procedure, the lender is not allowed to take legal action or continue collection efforts after 120 days have passed. Any subsequent efforts to recover uncollected balances must be undertaken by the government.

The following implications can be drawn with regard to the comparative effort and expense incurred by lenders on uninsured consumer instalment loans and GSL's:

1. The credit screening effort is substantially lower on GSL's with the costs of placing a loan on the books correspondingly lower. Some costs of placing the loan on the books of the lender are borne by the educational institutions.
2. The costs of monitoring and servicing loans during the period while the borrower is in school are considerably lower on GSL's than on other consumer instalment loans. On the other hand, the cost of monitoring and servicing loans during the repayment period is potentially much higher, due to deferments.
3. Because of the GSL requirements for reimbursements of defaulted accounts, some collection effort and expense is passed on to the federal government which might have been incurred by lenders if the loans were uninsured. Yet the nature of a student loan in

the repayment period suggests that delinquency and deferments could be considerably higher, leading to higher servicing costs for GSL's. The result is greater uncertainty about prospective costs.

To sum up this comparison of GSL's and consumer instalment loans made by lenders participating in the GSL Program, the following observations are relevant. The overall planning for the initiation of GSL's appears to be cursory, the evaluation of the creditworthiness of applicants is casual at best, the servicing of GSL's by lenders is comparable to the servicing of uninsured instalment loans of similar size, and the handling of delinquent accounts is marginally adequate due to the requirements for establishing claims for reimbursement. The generalizations reflect the fact that most lenders would not make student loans without a guarantee of the principal lent, even at market interest rates. Yet despite a federal guarantee and the combined interest subsidy and special allowance, it simply does not pay most lender participants to exert the same effort and incur the same costs as they would if the loan were uninsured and a free market price charged the student. However, one caveat must be added. The generalizations made do not necessarily apply to some institutions that have chosen to specialize in the granting of student loans (with guarantees). Such institutions have developed an in-house expertise that has resulted in efficient servicing and collection of GSL's. Other private institutions have specialized in taking over the billing and collection of student loans for lenders that are willing to pay the requisite fees. In the overall picture, however, these institutions appear to be the exception, and not the general rule.

III. The Importance of Sallie Mae on Loans Made of GSL Lenders

It verges on understatement to say that Sallie Mae plays an important and growing role in the GSL market. For many individual lenders, GSL's would not be made without the secondary market provided by Sallie Mae, despite the existence of a guaranteed gross return pegged to the Treasury bill rate and insurance against default loss. Sallie Mae's original function, as a 1972 Congressionally-chartered private corporation owned entirely by institutions participating in the GSL and Health Education Assistance (HEAL) programs, is to improve access to student loan credit for eligible students and their parents.. Sallie Mae's primary function is to maintain a secondary market by purchasing student loans from qualified institutions and to make advances secured by GSL's to these institutions. The essence of Sallie Mae's activity has been to provide liquidity to the student loan market. More recently, it has expanded its function slightly by providing liquidity to these same institutions by making advances collateralized by any obligations issued or guaranteed by the federal government or federal agency. However, for many institutions making GSL's, the main appeal of Sallie Mae is the opportunity it provides to sell GSL's to Sallie Mae before the repayment period begins. Until 1981, Sallie Mae's loan purchase program was limited to the purchase of loans that Sallie Mae would service. In 1981, the agency began a program that gave the seller the opportunity to service the student loan for a fee provided by Sallie Mae.

A. The Sallie Mae Loan Purchase Program

Sallie Mae markets its loan purchase program by stressing that the

profitability of a GSL to the lender is higher while the borrower is in school than when the borrower has negotiated the repayment schedule. The argument appeals both to lenders with a limited capacity to make student loans and to large volume lenders who wish to maximize their profit relative to their alternative lending opportunities. For example, a large volume GSL lender may find that selling some portion of its GSL's to Sallie Mae while maintaining sufficient volume of loan servicing is more profitable than handling the larger portfolio of GSL's during the 10 to 15 year life of the loan.

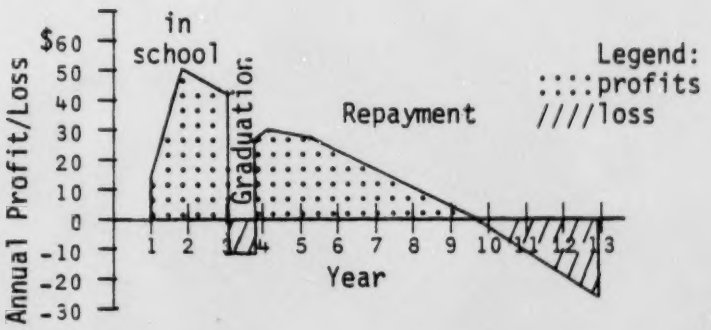
Figure 1, reproduced from a Sallie Mae marketing pamphlet, makes the point clearly for prospective customers using a "sample" loan as an explanatory vehicle. Note that even without discounting the relevant dollar amounts for their present values, the average profitability of the three year student loan (approximately $37) is greater than the $30 profit in the fourth year and the years that follow.

The loan purchase program has become a significant element in the GSL market, as indicated in Table 1. Although Table 1 understates the level of Sallie Mae's participation in the GSL market because its outstanding loans are average for the year and the GSL outstanding is at the end of the fiscal year (September), the trend over the five year period is obvious. Since Sallie Mae's purchases occur shortly before the repayment period, the better comparison of holdings is with the repayment period portion of the GSL outstanding balance. Between 1976 and 1981 Sallie Mae's share of the repayment total grew from 8.6 percent to over a third (34.8%) of the market

FIGURE 1

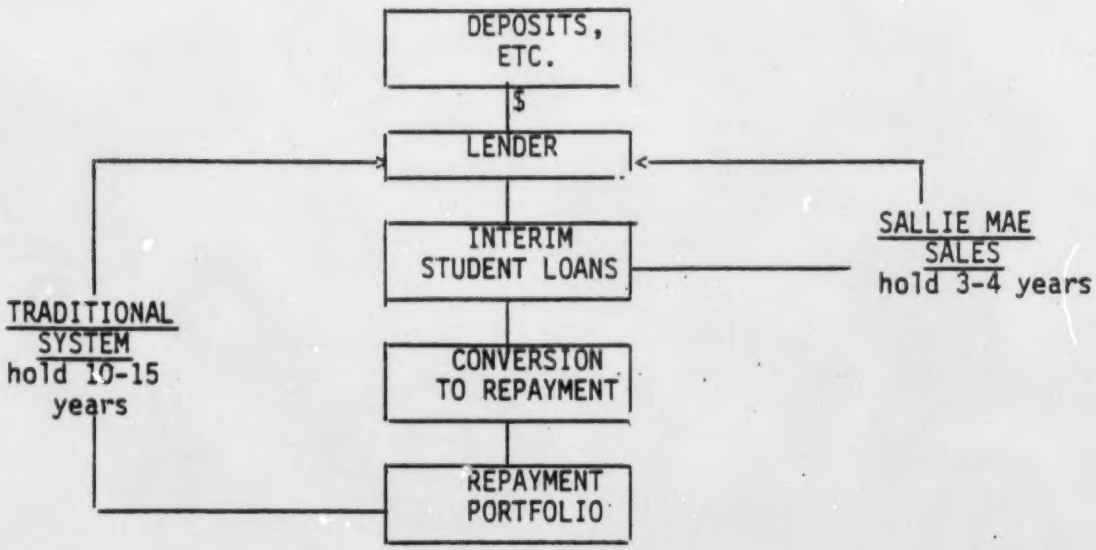
SELLING LOANS TO SALLIE MAE

The expense of owning student loans becomes substantially greater after the student graduates, due to their unique terms. It is then that the lender must, with each student, arrange a repayment schedule, execute an amortizing note, and begin collection efforts. By selling in-school loans prior to the borrowers' graduation, the originating lender may achieve liquidity and avoid the often difficult and lengthly rewrite and repayment stage of the student loan life cycle.



Profit/Loss over the life of a sample student loan.

Under the Loan Sale Program, Sallie Mae assumes responsibility for converting interim loans to repayment, and for collecting and servicing the loans over the payout cycle, which can be in excess of 10 years. The lender should not have to increase staff or servicing resources, since the effect of selling loans to Sallie Mae reduces the portfolio of loans in payout status, keeping administrative costs at a minimum. By thus reducing the burden of maintaining a large payout portfolio, many lenders find it easier to increase annual originations. This effect of turning over student loan inventory more frequently increases the number of potential future customers for the lender. The funds derived from selling loans to Sallie Mae can be used to make new student loans or for any other purpose, as there is no reinvestment requirement.



Lenders gain liquidity and relief from servicing cost under the Loan Sale Program.

(End of Figure 1)

by 1981. Meanwhile, as in-school lending grew rapidly during the period, Sallie Mae's share of the total market did not grow as greatly but did more than double, rising from 3.8 percent to 8.4 percent. Its share will rise further as enrolled students leave school.

How does Sallie Mae provide the servicing that many eligible institutions do not wish to provide? It contracts loan servicing out to a number of private organizations that specialize in that activity. Contracts are made with one servicer for each (state) guaranty program. In addition to using private servicing contractors, Sallie Mae established a Student Loan Repayment Center in April 1980 to provide capacity for servicing additional loan volume.

TABLE 1

SLMA Average Student Loan Purchases Outstanding as a Percentage of GSL's Outstanding at the End of Fiscal Year During the Repayment Period and Total Outstanding, 1977-81

Year	SLMA student loan purchases, net (millions of $)	SLMA percentage of GSL's outstanding during repayment period	SLMA percentage of total GSL's outstanding
1977	233.9	8.6	3.8
1978	329.6	11.6	4.8
1979	555.8	17.8	6.7
1980	975.7	26.0	8.5
1981	1,602.6	34.8	8.4

Sources: 1981 Student Loan Marketing Association Annual Report, Office of Student Financial Assistance, U.S. Department of Education.

What kind of loss rates are experienced by Sallie Mae in servicing consumer loans? By taking claims and resales on student loans purchased as a percent of average student loan purchases outstanding during the year from the 1981 Annual Report, the following percentages are:

1981 - 5.7%
1980 - 4.6%
1979 - 3.5%

The upward trend in default rates may be indicative of the problems that come with growth. Yet loss rates in the GSL program as a whole appear to be substantially higher during those three years averaging about 9 percent.[7] When compared to commercial bank losses on consumer instalment loans in the Federal Reserve's 1981 Functional Cost Study, Sallie Mae's loss rates run from five to eight times as high. For example, the comparable figures for losses in percent of outstanding consumer instalment loans in 1980 in a sample of commercial banks in three size groups were:[8]

	net losses in percent of outstanding volume	
	1980	three year average
Large banks (deposits> $200 mil.)	.69	.64
Medium banks (deposits $50-200 mil.)	.58	.46
Small banks (deposits< $50 mil.)	.83	.58

Clearly commerical banks find servicing student loans a very different business from servicing uninsured loans, fearing the relatively high rates of delinquency accompanying default. Even though default losses are insured, the lender must await reimbursement for claims, a process that may take up to a month, or longer in exceptional cases.

Sallie Mae generally limits purchases to loans that are in interim status (in-school students), fully insured, free of any incumbrances, and representing all of the insured loans made by the selling institution to any one borrower. Sallie Mae prices the loan purchases as a percentage of the outstanding principal balance based on average characteristics of the portfolio offered for sale. Two characteristics are involved in the pricing process: the size of the average borrower balance and the average months remaining to maturity. The Sallie Mae representative will help institutions structure the sale to achieve a 100 percent price for the balances offered. Put simply, this means that Sallie Mae has a cutoff point with respect to size and maturity, below which too small sizes and/or too short maturities require a discount of loan balances to meet its own profit standard. In providing liquidity to participants in the loan purchase program, Sallie Mae only competes for the purchase of those loans which, in a package, justify the costs of handling the loans over the remaining period to maturity.

The second means by which Sallie Mae adds liquidity to the guaranteed student loan portfolios of participating institutions is to make advances to institutional borrowers for periods of time between one and twelve years by pledging student loans as collateral. The borrower must agree to either maintain its portfolio of insured loans at a level which is not less than the principal balance of the portfolio on the date of the financing or to originate student loans equal to the amount of the advance by the maturity of the advance. In addition to its warehousing advance program, Sallie Mae extends lines of credit on a fixed or revolving term basis and makes forward commitments guaranteeing future access to the warehousing advance program at pre-arranged rates and terms.

Sallie Mae's rate for making advances is a floating rate pegged at 1½ percentage points above the three month Treasury bill rate at the beginning of each quarter. Sallie Mae markets this program by noting that an institution can help assure a positive spread of two percentage points between the floating rate it received on student loans (3.5 percentage points above the 3 month Treasury bill rate) by matching maturities of a student loan portfolio with the maturities of its advances (3½% less 1½% equals 2%). This gross yield of two percentage points has to cover the administrative costs of servicing the loan.

The warehousing advance program has been as popular as the loan purchase program with Sallie Mae's customers. Since advances may be made on the basis of the in-school and repayment period balances held by the participating institutions, the more appropriate comparison is between the amount of Sallie Mae advances in proportion to average total GSL's (Table 2). Between 1977 and 1981, Sallie Mae advances as a percent of average total GSL's outstanding has more than doubled, from 3.8 percent to 8.4 percent. Further, by comparing absolute amounts between Table 1 and Table 2, one can note that beginning in 1979, advances outstanding were larger than purchased loans outstanding on Sallie Mae's books.

The best measure of the overall importance of Sallie Mae's importance to the GSL market occurs when both the loan purchase and warehousing advance programs are combined and expressed as a percentage of average loans outstanding. This measure omits the agency's other activities in aiding participating institutions. Table 3 indicates that Sallie Mae's proportion of the GSL market grew from 7½ percent to almost 20 percent over the five year period. Further, it is highly impressive that Sallie Mae would have held more than 20 percent of the GSL's outstanding if its holdings at the end of September were available (at year end, Sallie Mae's holdings were 25 percent of the September total).

TABLE 2

SLMA Average Warehousing Advances Outstanding
as a Percentage of Total GSL's Outstanding
at the End of Fiscal Year, 1977-81

Year	SLMA warehousing advances (millions of $)	SLMA percentage of total GSL's outstanding
1977	231.9	3.7
1978	324.4	4.7
1979	566.6	6.8
1980	1,072.6	9.2
1981	2,177.0	11.5

Sources: 1981 Student Loan Marketing Association Annual Report, Office of Student Financial Assistance, U.S. Department of Education.

TABLE 3

SLMA Average Student Loan Purchases and Warehousing Advances Outstanding as a Percentage of Total GSL's Outstanding at the End of Fiscal Year, 1977-81

Year	SLMA loan purchases and warehousing advances (millions of $)	SLMA percentage of total GSL's outstanding
1977	465.8	7.5
1978	654.0	9.4
1979	1,122.4	13.5
1980	2,048.3	17.6
1981	3,779.6	19.9

Sources: 1981 Student Loan Marketing Association Annual Report, Office of Student Financial Assistance, U.S. Department of Education.

Sallie Mae operates on a relatively narrow interest margin between the cost of borrowed funds and its gross yield on student loans, warehousing advances and short-term investments. It has a privileged position as a borrower since it has been granted "federal agency" status in the capital markets. Behind this status is a $1 billion line of credit from the U.S. Treasury, the right to sell obligations backed by student loan collateral in unlimited amounts to the Federal Financing Bank (a unit of the U.S. Treasury) and a host of other "eligibility" considerations that accrue to institution's holding Sallie Mae's debt. Its gross income is the combined return from purchased student loans (3½% above the quarterly 3 month T bill rate), the return from warehousing advances (1½% above the quarterly 3 month T bill rate) and whatever return it obtains from its short-term investments.

When Sallie Mae's interest expense is subtracted from its interest income and expressed as a percentage of its earning assets, it is called the net interest margin, indicating the interest spread from which it must cover all of its expenses of operation. While this margin has narrowed considerably over the past five years, the growth in the size of Sallie Mae resulting from the increases in assets has brought with it greater leverage (the ratio of liabilities to equity) that has permitted the return on average equity to rise from 14.3% in 1977 to 30.5% in 1981 (Table 4). Despite the rise in the return on equity, the narrowed net interest margin is a source of concern, since leverage is a two-edged sword. If the net interest margin narrowed substantially or if it remained the same and there were a sharp rise in servicing and administrative costs, the extremely high leverage ratio could convert large profits into large losses. Thus, Sallie Mae's currently profitable condition could deteriorate quickly if either or both contingencies occurred.

TABLE 4

SLMA's Net Interest Margin, Leverage Ratio and Return on Equity, 1977-81

Year	Net interest margin[a] (percent)	Leverage ratio[b]	Return on equity[c] (percent)
1977	2.21	15-1	14.3
1978	2.12	20-1	17.1
1979	1.46	29-1	15.7
1980	1.28	45-1	20.1
1981	1.26	68-1	30.5

Notes: a) Net interest margin is the net interest revenue as a percent of average earning assets.
b) Leverage ratio is SLMA's average total liabilities divided by its average stockholders' equity.
c) Return on equity is net income, after taxes, as a percentage of average stockholders' equity.

Sources: 1981 Student Loan Marketing Association Annual Report.

This review of Sallie Mae's activities in the GSL market, in summary, indicates that:

1) Sallie Mae's loan purchase and warehousing advance programs have provided liquidity to participating lenders by purchasing or advancing funds for one-fifth of the GSL market.

2) Loss ratios on loans purchased by Sallie Mae are considerably higher than those on uninsured bank consumer instalment loans but below loss rates on GSL's generally.

3) Due to its preferred position in debt markets, Sallie Mae has maintained a positive, but narrow, net interest margin out of which it has been able to cover administrative and servicing costs and make a profit.

4) Profitability of Sallie Mae could be threatened and the high return on equity erased by further narrowing of its net interest margin, increases in servicing costs or a combination of the two.

IV. GSL past growth and future problems

Clearly, there has been a strong upward trend in guaranteed student loans, reflected in both the number and amount of outstanding loans. By September, 1981 there were almost fifteen million students and former students indebted in the total amount of $19 billion (Table 5). Over the decade, the annual growth rate was 15 percent per year in the number of students and almost 20 percent per year for the dollar amount of student debt. Clearly, the program has facilitated the education of many students, three-fifths of whom were still in school in 1981.

The growth rates for the in-school portion of students in the program accelerated greatly in the second five years shown in Table 5. During the repayment period the growth rate slowed in the second five years, despite the sharp increase in the number of in-school students. However, since many such students have not yet left school, one can look for sharper increases in

TABLE 5

Growth in GSL's Outstanding; Number and Amount of Loans During In-School Interim Period and During Repayment Period, 1972-1981

Year	GSL's outstanding, end of fiscal year					
	In-school		During repayment		Total	
	Number (000)	% of total number	Amount (millions of $)	% of total amount	Number	Amount (millions of $)
1972	2,380	66	800	26	2,602	3,085
1973	2,519	58	1,203	32	4,354	3,702
1974	2,519	51	1,501	37	4,987	4,080
1975	3,517	44	1,877	41	5,158	4,548
1976	2,973	46	2,363	42	6,436	5,676
1977	3,015	41	2,705	44	7,385	6,193
1978	3,258	41	2,847	41	7,886	6,925
1979	3,948	45	3,122	38	8,709	8,302
1980	5,511	52	3,751	32	10,500	11,649
1981	9,102	62	4,600	24	14,677	19,000
Ten year annual growth rate	14.4%		19.1%		15.1%	19.9%
1st five year annual growth rate	4.5%		24.2%		12.3%	13.0%
2nd five year annual growth rate	24.7%		11.2%		14.7%	25.1%

the growth rate of amounts in the repayment period in the years ahead.

The cost of the program has grown substantially since 1973, to a level of about $2.5 billion in 1981 (Table 6). Such costs should be examined both in absolute dollar amounts and those amounts expressed as a percentage of outstanding GSL student indebtedness. The ratio of total federal GSL costs to outstanding GSL debt (labelled the federal cost ratio) rose from 8.3 percent in 1973 to a peak of 13.7 percent in 1980, declining slightly, in the 1981 estimate. This sharp rise in costs has occurred mainly with the rise in market interest rates, causing the interest subsidy and special allowance payments to rise sharply. As this paper is concerned primarily with credit policies of participants, little else will be said about interest rate differentials, although they exert an extremely important influence upon program costs.

Default-related costs are, however, directly concerned with credit policies, and they have remained high, as noted earlier. Table 7 notes that default costs in percent of GSL's outstanding during the repayment period peaked at 10 percent in 1975 and have remained relatively high, between eight and ten percent since 1978. Default costs are high and will remain high for two reasons. First, students are a high risk borrowing population because they are a highly mobile, young group that has built up little or no previous borrowing experience because private credit is not readily available to persons without regular employment. Further, without previous borrowing experience, repayment habits have not been built so that no credit record exists to demonstrate reliability in meeting payments. Second, student guaranteed loans are for a longer duration than would be

TABLE 6

Federal Costs for Guaranteed Student Loans as a Percentage of Outstanding GSL Student Debt, 1973-81, Selected Years

Year	Total Federal GSL costs (millions of $)	Outstanding GSL student debt (millions of $)	Federal cost ratio (%)
1973	306	3,702	8.3
1975	506	4,548	11.1
1977	548	7,193	8.8
1978	705	6,925	10.2
1979	999	8,302	12.0
1980	1,598	11,649	13.7
1981 (est.)	2,535	19,000	13.3

Sources: Guaranteed Student Loans: A Background Paper, National Commission on Student Financial Assistance, March, 1982, page 22: Office of Student Financial Assistance, U.S. Department of Education.

TABLE 7

Federal GSL Default Costs as a Percentage of Outstanding GSL Debt in the Repayment Period, 1973-81, Selected Years

Fiscal years	Federal default costs[a] (millions of $)	Outstanding GSL debt in repayment period (millions of $)	Federal default cost ratio (%)
1973	64	1,203	5.3
1975	189	1,877	10.1
1977	198	2,705	7.3
1978	261	2,847	9.2
1979	302	3,122	9.7
1980	333	3,751	8.9
1981	370 (est.)	4,600	8.0

Note: a) Reimbursed claims and related operating expenses

Sources: Guaranteed Student Loans: A Background Paper, National Commission on Student Financial Assistance, March 1982, page 22: Office of Student Financial Assistance, U.S. Department of Education.

granted on an uninsured, unsecured loan to the highest grade consumer instalment loan applicant. The chances of not obtaining employment are higher for students entering the work force than for employed persons to lose jobs, and there is no proven record of earning capacity sufficient to carry through repayment of a thirteen to fourteen year loan.

There are several problems which can be expected to emerge in the future. First, there will be a large number of student loans entering the repayment period in the years ahead which will either be sold and serviced by Sallie Mae or serviced by participating lenders (or their agents). The narrow profit margins may disappear if there is a rise in servicing costs or the inability to service these higher volumes at reasonable costs. With a higher proportion of GSL loans in the repayment period, the volume of claims for default will increase with associated increases in delinquency before default can legally occur, adversely affecting profitability for both the secondary market purchasers and primary lenders. Second, a rise in defaults will greatly expand the costs to the federal government which, if not offset by declining interest rates, will pose budgetary problems. Third, continued growth of the GSL program will add pressures to the demand for funds on capital markets. If Sallie Mae continues to expand its proportion of the GSL program's uses of capital funds, there will be further concern about government sponsored corporations crowding out private demands for capital.

If these contingencies occur, it is important that the credit policies involved in the GSL Program be above criticism. I would cite four areas of concern:

1. the lack of screening credit applicants for their prospective creditworthiness.
2. criticism that students are not using GSL funds to finance their education.
3. that Sallie Mae remains a viable intermediary in the GSL market, and
4. that participating credit institutions will maintain their support of the GSL program.

It may be noted that the second area of concern has not been discussed in the review of credit policies. It is listed because of a brief discourse between a financial counsellor hosting a talk-show on local radio in New York City on Saturday, August 25, 1982.

The interview began like this:

Host: Hello, Jerry, are you there?

Caller: Hi, Bob, great show!

Host: Thanks, Jer, what can I do for you?

Caller: I've got $2,500 to invest and I thought you might help me.

Host: Glad to, but you need to tell me a little more about yourself. How old are you, how much income do you earn and what other assets do you have, Jerry?

Caller: I'm a student at _____, and I don't have any other assets, which is why I called. Do you think I should put the money in a money market fund or do you think I could invest in something better?

Host: Now, just a minute Jerry, how come you have $2,500 to invest if you're a student?

Caller: It's a student loan which I want to invest, as I don't need the money right now for school.

Host: Why did you borrow the money if you don't need it for your education? Don't you know that funds of that kind are limited?

Caller: (hesitantly) The money was there.

Host: Hang on a minute, Jerry, let's talk some more after I run a commercial message.

Note: The commercial message is run.

Host: Now, Jerry let's talk some more. Don't you realize that you might drprive another student of the opportunity to borrow because you've used up the funds?

Caller: (had hung up during the commercial message)

In this sequence, the host jumped to the conclusion that the caller did not need the loan and was simply profiting from reinvesting his subsidized loan proceeds at a higher market rate than that charged on a GSL. The caller could have said he would use the extra interest to help pay future educational expenses, but he did not. One thing is certain. The publicity given student loans for what is a wide audience in New York City at breakfast time was not good!

In the next section, recommendations are made to alleviate the four concerns listed above.

IV GSL credit policy recommendations

The following recommendations are discussed briefly as remedies for the concerns noted earlier:

A. Provide federally-sponsored research on the derivation of empirical credit scoring systems on student loans

B. Make preauthorized debits to deposit accounts a requirement for students repaying loans

C. When GSL's are approved, pay reimbursement to the schools where the student is enrolled, against which charges for tuition, books, room and board could be made. For commuting students, allowances could be made and the students reimbursed for sums covering commutation, room and board as approved by the guaranty agency. The school could retain interest earned on such funds held during the escrow period to offset the administrative expenses incurred.

D. At some point during the repayment period provide the student with an option to prepay the loan at a discount, based on the current market rate for a U.S. Treasury obligation of similar remaining duration.

E. Encourage Sallie Mae to conduct research on performance scoring techniques to improve the efficiency of servicing problem accounts at its Repayment Center. Numeric scoring systems on collections, if pilot programs indicate improvement, could be required of servicing agents used by Sallie Mae.

F. The federal government should request the Federal Reserve to include student loans as a specific element in its functional cost analysis for participating commercial banks. This would help participating bank lenders compare their costs with the costs of other participants and better cope with the decision to sell student loan paper to Sallie Mae, to attempt to service the paper themselves, or to stay out of the GSL market.

A. The first recommendation is made to provide better procedures to screen credits than those currently in use. Graduate students, for example, have had time to establish credit repayment habits which could be appraised and numeric scoring of applications developed. For

undergraduate students, research may reveal that it is possible to predict creditworthiness from information collected about the student on the application form, particularly if information about non-educational indebtedness were included. Sall Mae's files could produce a sample of completed loans that could identify the elements that distinguish loans with satisfactory repayment (good loans) from those that do not (bad loans). Further, Sallie Mae could adjust its standards for purchasing student loans and measure the effectiveness of any new system by utilizing it in some test segments of its nationwide market.

B. Banking institutions that accept direct deposits of paychecks through the automated clearing house network (ACH's) are required to accept preauthorized debits to depositts as well. Such preauthorized debits would add to the discipline of student repayment habits besides ensuring that student loans get the same priority in repayment as other preauthorized payments such as insurance. It is unlikely that students would elect preauthorized debits to deposit accounts if the system were voluntary, so it would need to be made a condition of the loan.

C. To limit criticism that loan proceeds are used frivolously, the university or school should receive the loan proceeds and allocate them to approved expenditures. Limiting student-approved expenditures to tuition, books, room and board with commutation added for commuting students would exhaust the proceeds of most GSL student loan limits. Charging the school with administering the loan proceeds, if kept simple, would not be inappropriate if interest from funds held in escrow covered the administrative costs.

D. The reason that any student has an incentive to borrow as much as possible and reinvest the proceeds at a market rate of interest is because the existence of a subsidized interest rate brings the opportunity to earn more on the difference between the subsidized rate and the market rate. This means that at any point in its life, the student loan has a greater market value than its face amount if the loan were salable to a third party. It is possible to capitalize on this situation to encourage prepayment of GSL's at some point where the remaining profitability of the loan is zero. At some point the servicer of a student loan is indifferent as to prepayment since the remaining payments include some which are profitable and some which are not (return to Figure 1, from the Sallie Mae pamphlet). In Figure 1, the loan is profitable between the fourth and tenth year while the eleventh through thirteenth years are unprofitable. From the seventh to the thirteenth year the net profit from servicing a loan is about zero, so the lender is indifferent then to prepayment and gains if prepaid after the seventh year. So, why not offer the borrower the opportunity to recoup the capital gain inherent in the loan by offering an incentive to prepay by discounting the future payments over the remaining period at a market rate and allowing prepayment of the present value at that time. The following example is illustrative:

Loan: $5,000

Term: 120 months, 60 months have been paid off.

Monthly payment @ 9% = $63.34

Unpaid principal: $3,028.12

Market rate: (5 year U.S. Treasury bond): 15%

Present value of an annuity of $63.34 per month for 5 years @ 15% $2,662.47

By giving the borrower the opportunity to prepay $3,028.12 of debt for $2,662.47 five years before it matures, the borrower may recoup $365.65 in debt owed. Counting on the fact that it is a nuisance to make payments under the current system (no preauthorization) and some costs are involved as well in making payments (postage, etc.), the borrower may be willing to forego the tax deduction on interest payments and prepay the loan. Why should the federal government offer the oppportunity? The government is stuck with the interest subsidy anyway, and is indifferent to the prepayment decision at that moment. The borrower may be influenced by his guess about the course of future interest rates, but that is a risky game with little expertise apparent anywhere. If the loan servicer and the government are indifferent to prepayment, the chances are that many borrowers will not be. There is much to be gained by lowering the size of outstanding student debt in this, or any other way. Default risks are lessened, and there are political advantages to keeping GSL total debt outstanding at lower levels. It may advance some of the costs of the GSL program which might otherwise be spread out over future years but there is no apparent net cost to the government from making the option available.

E. Performance scoring is the application of credit scoring principles to identify a set of collection techniques and methods that improve the efficiency of collecting problem accounts. Sallie Mae, which must maintain efficiency in servicing loans purchased, should be constantly investigating methods which have proven effective in the private sector, if they are not already doing so. They have all of the advantages of scale, covering a nationwide market, and are in a unique position to benefit from any such economies, if available.

F. Finally, means must be found to involve members of the banking community more closely in the planning of their student loan participation, the assessment of procedures for minimizing costs, and a closer appraisal of the expected profitability of such activity so that they can measure and monitor their performance. A first step in this direction is the collection and dissemination of the results of a uniform method of measuring costs so that individual banks can compare their performances against results for groups of banks in a similar size category. The Federal Reserve System makes such an opportunity available to banks today for all major classes of loans and deposits. What would be useful to GSL lenders would be for the Fed to provide comparable information about GSL costs, revenues and break-even loan amounts as they do now for consumer instalment loans generally and for credit cards.

To conclude, these recommendations could benefit from further research and exploration of their feasibility. They are important, however, as they point toward improvement of credit policies to make the GSL program more effective, rather than toward reducing its scale for other reasons.

FOOTNOTES

1. Guaranteed Student Loans: A Background Paper, National Commission on Student Financial Assistance, Washington, D.C., March 1982
2. Kendis, Kurt, "Final Report of Results: A Review of the Guaranteed Student Loan Special Allowance," prepared for the National Commission on Student Financial Assistance by the Wharton Applied Research Center, The Wharton School, University of Pennsylvania, June 30, 1982; Gordon, Dr. Kenneth F., and Errecart, Michael, "A Survey of Lenders and Borrowers in the Guaranteed Student Loan Program," prepared for Office of Planning, Budgeting, and Evaluation, Office of Education, U.S. Department of Health, Education, and Welfare, November 14, 1975
3. Kendis, Section B.4, page 9
4. Guaranteed Student Loans: A Background Paper, p. 5
5. Ibid., p. 41
6. Gordon Survey, responses to question #20
7. See Table 7
8. Functional Cost Analysis, 1980 Average Banks, Board of Governors of the Federal Reserve System, 1981, pp. 27, 29-31
9. SLMA's Line of Credit and Forward Financing Programs are not included in the measure.